BBVA Research

Colombia

Economic Outlook

Second Quarter of 2010

Economic Analysis

- Recovery has been quicker than expected.
- Expected GDP growth will not be strong enough to push up inflation in 2010 and 2011.
- In the following months Banco de la República will face the dilemma of keeping FX intervention without compromising the inflation target.
- New efforts to improve fiscal balance will reduce the impact of financing the deficit on the FX and the domestic debt markets.

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Executive Summary

Recovery has been quicker than expected, supported by domestic demand with significant growth in consumption and a slower upturn in investment. However, the economy might move towards an increase in world risk aversion levels caused by the crisis in Greece. A worsening of these together with falls in commodity prices could affect the cost of debt and slow down growth.

Recovery will not be strong enough to push up inflation in 2010 and 2011. We expect an appreciation in the Colombian peso in the medium-term. Against this background, the monetary authority is faced with the dilemma of pursuing intervention in the foreign exchange market without compromising the inflation target. The Government must improve the fiscal balance to reduce the impact of financing the deficit on the foreign exchange market and the domestic debt market.

The challenges ahead for sustained global recovery

In the past few quarters, the economic situation has improved considerably due to the upturn in emerging economies and in the US. World trade is growing at a rate of 7% and our forecasts hint at 4.2% growth in the world economy in 2010. However, doubts remain regarding the EMU's capacity to tackle the problem of high debt levels in some countries. These doubts have led to an increase in sovereign spreads and a new period of financial instability. This situation could affect the European economy, but it could also spill over to the rest of the world. The timing and the scope of these adverse impacts will crucially depend on the effectiveness of the announcements that the European Council made on 9 May regarding the agreed rescue packages and the ECB's special measures. Although these packages have stabilized market conditions in the short-term, uncertainties still lurk on three fronts: i) the rescue package implementation process over the coming months ii) credibility regarding an additional fiscal consolidation in some EMU countries and iii) the medium-term obligation on central EMU countries regarding the rescue packages.

While economic recovery was widespread at the start of 2010, its intensity varies widely between countries. This is due to the varying degrees of use of fiscal and monetary policies. These policies have been particularly effective in boosting the economic cycle in China and the US. At the same time, emerging economies are benefiting from the growing strength of their domestic demand and from the upturn in terms of trade, in a climate of reduced risk aversion. In this region the recovery is therefore much more consolidated. On the other hand, in developed economies, as the expansive policies ease, questions arise regarding the sustainability of the recovery beyond 2010.

The FED is expected to push interest rates up gradually. The first rises are predicted at the start of 2011, with rates slightly above 1% by the end of that year. The differences in the economic fundamentals in the US and the EMU will lead to different monetary policy exit strategies in both regions. Although economic growth could be slow from 2010 onwards, the risk of a reversal of the current trend is limited in the US and inflationary pressure is still in a very early stage. However, in the EMU, as well a much more fragile financial situation, the cyclical improvement seems to be uncertain and there are no indications of inflationary pressure. As regards monetary policies in emerging economies, there is no doubt that they need to be toughened. Given the cyclical discrepancies in this region, the exit strategies will vary from country to country. If in some economies the toughening of the monetary policy and other measures are not implemented in time, increasing imbalances could be generated.

In times of greater risk aversion, financial markets tend to be more forward-looking. Financial markets are efficient when it comes to detecting inconsistencies in macroeconomic policies that usually go unnoticed in times of economic boom. In spite of the large rescue package agreed in Europe, significant risk premiums will persist on the sovereign debt market in some European countries in the midst of uncertainties regarding fiscal consolidation processes. The growing contagion has been clear proof of the fragility of the current situation. Economic history is full of examples of "unfounded contagions" across borders in times of crisis. In these cases, geographical proximity or cyclical similarities are more important than differences in terms of fundamentals. In fact, the current contagion situation is not completely justified by either the financial channel spurred by the breakout of the crisis in Greece or by any similarity in terms of fundamentals. Even though this may be cause for debate, there is a compelling need for some countries to increase their credibility to face the pressure from international investors.

There is growing concern over the long-term consequences of increases in public debt. In developed countries this will inevitably led to upward pressure on real interest rates and high risk premiums for a long time. Even if the recent contagion gradually fades, there will be growing discrimination between countries depending on the credibility of their fiscal situation.

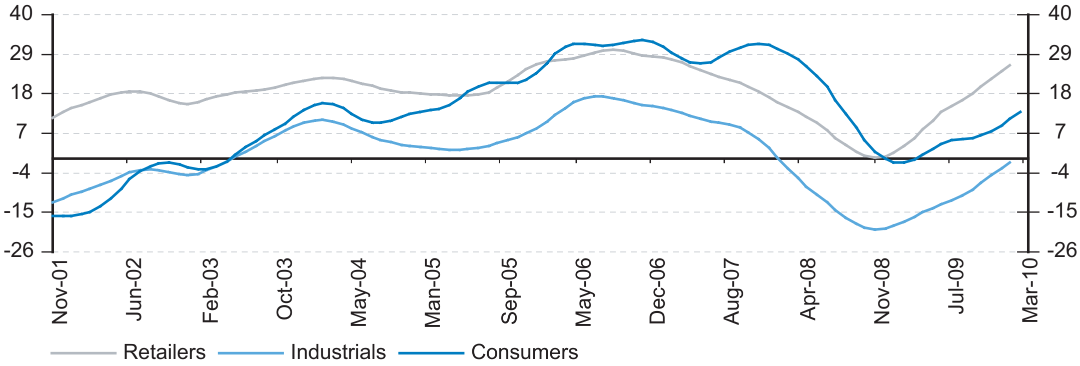
There are two main types of uncertainty from the financial sector. Firstly, the slow restructuring of the financial industry, especially in Europe, which could bring about a creditless recovery. This is an increasing concern, because past experience and empirical evidence show the importance of the credit channel in the first stages of economic recovery. There is also uncertainty over the regulatory reform that is already underway. The most likely result is a significant increase in capital and liquidity requirements, which could limit banks' capacity to award credit over the coming years.

Better performance in private spending hints at recovery

The quick recovery in confidence levels following the 2008-2009 crisis hints at a better performance than expected in private spending during 2010, replacing the public stimulus as the main source of growth. This was possible insofar as household and company balance sheets were not seriously affected during the last cycle. The monetary stimulus allowed the household debt burden to be lowered, increasing their willingness to borrow for consumption and investment.

Chart 1

Confidence Index: Consumers, Retailers and Industrials (Seasonally adjusted series)



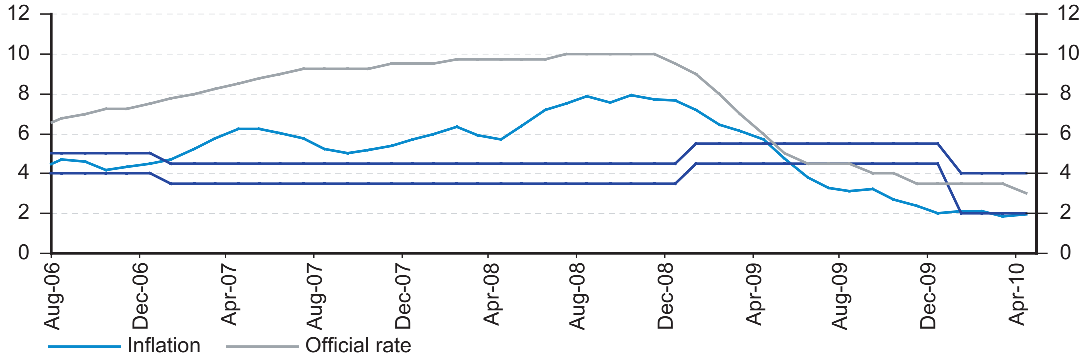
Source: Fedesarrollo and Colombia BBVA Research

The BBVA Research Colombia growth forecast for 2010 and 2011 rose to 3.0% and 4.4% yoy, respectively. Further increases cannot be ruled out if the recent improvements in activity indicators become consolidated. Increases in machinery investment and building licenses could hint at a more dramatic increase in private investment than forecast.

The fiscal deficit in 2010 will probably be lower than the Government estimates (4.3% vs 4.5% of the GDP) in light of an improved performance of tax receipts and a greater contribution from oil revenue. Nonetheless, the decline in fiscal balances over the past two years has been noteworthy considering that at the moment the deficit is almost twice that recorded in 2008. This situation has increased the dependency of foreign and domestic debt issuance, creating distortions in the exchange rate and the rates of treasury securities (TES).

Increased growth in domestic demand will involve a slight rise in the current account deficit. No problems to finance it are anticipated though, because it is covered by foreign direct investment flows, mainly targeted at mining and hydrocarbons. In the medium-term, these investment flows, the public borrowing trend and the positive terms of trade will continue to exert pressure on an appreciation in the exchange rate. BanRep will continue to accumulate reserves to curb this trend. The room for intervention could be limited, however, due to the reduced availability of sterilization mechanisms.

Chart 2
Inflation and BanRep official rate (yoy, %)



Source: Banco de la República and DANE and BBVA Research

During the first quarter, inflation remained below BanRep's long-term target range (between 2.0% and 4.0%). BBVA Research Colombia predicts 3.4% inflation in 2010 and 3.2% in 2011. This forecast considers further revisions to the domestic fuel price, an increase in food prices that were affected by fewer exports to Venezuela, and a slight upturn in traded goods prices in the second half of the year.

BanRep lowered the policy interest rate from 3.5% to 3,0%, a decision that surprised the market. This greater monetary stimulus is a reflection of a significant downturn in the central bank's inflation forecasts and a consideration of the country's reduced growth in relation to the region. BBVA Research Colombia expects that this policy interest rate level cannot be maintained until the end of 2010 in view of the current pace of economic growth and the inflation forecast which involves a real negative rate in the final quarter of the year.

The presidential elections will be held over the coming months. The political campaign debate has focused on strategies to promote job creation and formal employment, guarantee transparency in handling public funds, consolidate the fiscal balance and make progress on solving the armed conflict. The recent voting intention results show that the independent candidate (Antanas Mockus) is moving up quickly, followed closely by the party in power (Juan Manuel Santos), who until recently had a clear lead in the polls. The programs of both candidates are in keeping with an orthodox economic policy and continuity of the democratic security strategy, which has improved the country's investment climate.

Colombia is not immune to a decline in the foreign context

The increase in the Greek sovereign debt risk premium and the rising liquidity tensions could spread to emerging economies. In this contagion situation, capital flows towards the region will drop due to greater risk aversion. Insofar as fears of a longer recession in Europe come at the same time as a stronger monetary adjustment in China, there will be a decline in the terms of trade. The Colombian economy will therefore face a slower growth rate caused by a reduction in exports, a fall in the volume of remittances and lower household and business confidence. This will delay the recovery process that started in 2H09.

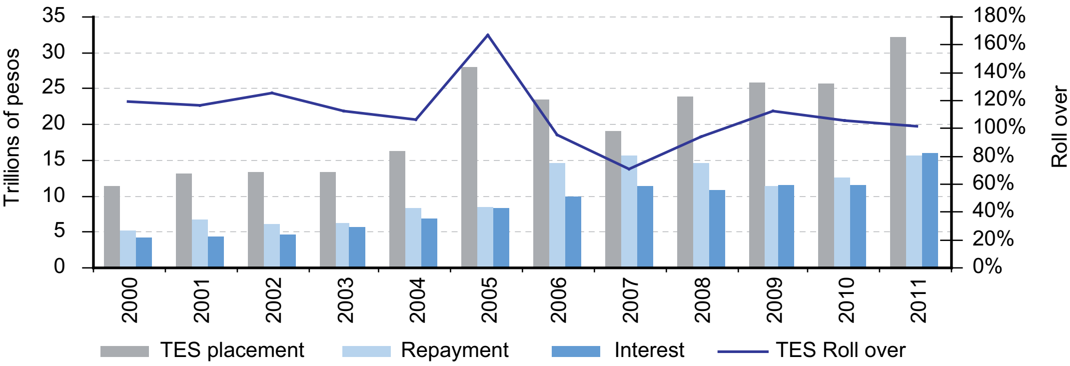
Furthermore, the drastic reduction in trade with Venezuela could have a permanent effect on some industrial sectors which will not be able to complete the market diversification process. The recent performance in exports shows that some branches of production with a high level of labor and aggregate value have not yet found new destinations for their foreign sales. This situation and the negative impact on growth in the manufacturing sector mean fewer sources of qualified labor.

New efforts to improve fiscal balance are necessary

The expected fiscal deficit trend hints at negative primary balances in the coming years, between -0.5% and -1.1% of the GDP, only stabilizing by 2014. A tax reform therefore needs to be passed in order to reduce these imbalances. Although public funds are not expected to be unsustainable, the needs for financing will put off the drop in public debt, which in turn will delay the reduction of the Colombian economy's vulnerability. In addition, the forecasts of considerable capital flows towards the mining and hydrocarbons sector have resulted in a proposal to create a fiscal rule that boosts foreign savings, strengthens the anti-cyclical nature of the fiscal policy and avoids a dramatic appreciation in the real exchange rate. Also, in the domestic context, the debt profile needs to be improved further, seeking to use the low scheduled maturity levels in the medium- and long-term and avoid the concentration of payments over the next three years. BBVA Research Colombia considers that these will be the priority economic issues for the new Government which takes over in August 2010. The two candidates with the most possibilities of winning the elections support a reform that guarantees a reduction in tax exemptions and a possible increase in the price of VAT.

Chrat 3

Internal debt Roll over



Source: Ministerio de Hacienda and BBVA Research forecast

BanRep is facing the challenge of implementing monetary management which allows the inflation target to be reached in a climate of exchange rate intervention and a possible moderate contagion effect regarding the turbulence in Greece. The central bank is up against restrictions to sterilize a prolonged intervention in the foreign exchange market due to the low balance of public debt securities in its portfolio and the quasi-fiscal cost involved in using other mechanisms such as issuing its own debt securities, in a context in which it expects losses this year. Bearing in mind that the pressure of an appreciation in the exchange rate is expected to continue in the medium-term, a decision by BanRep to maintain the exchange rate intervention would not be in keeping with the need to bring the monetary policy stance back to normal and would end by causing inflationary pressure in the medium-term.

Tables

Table 1
Macroeconomic Forecasts: Quarterly

	GDP (% y/y)	Inflation (% y/y, average)	Exchange Rate (vs. USD, average)	Interest Rate (%, average)
Q1 09	-0.5	6.1	2477	7.00
Q2 09	-0.3	3.8	2090	4.50
Q3 09	-0.2	3.2	1987	4.00
Q4 09	2.4	2.0	2016	3.50
Q1 10	**2.5**	**1.8**	**1909**	**3.50**
Q2 10	**2.4**	**2.4**	**1998**	**3.00**
Q3 10	**3.6**	**2.8**	**2016**	**3.00**
Q4 10	**3.3**	**3.4**	**1973**	**3.50**
Q1 11	**4.1**	**3.3**	**1953**	**4.00**
Q2 11	**4.5**	**3.1**	**1921**	**4.50**
Q3 11	**4.5**	**2.8**	**1859**	**5.00**
Q4 11	**4.4**	**3.2**	**1903**	**5.50**

Source: BBVA Research

Table 2
Macroeconomic Forecasts: Annual

	2009	2010	2011
GDP (% y/y)	0.4	3.0	4.4
Inflation (% y/y, average)	3.8	2.6	3.1
Exchange Rate (vs. USD, average)	2142	1974	1909
Interest Rate (%, average)	4.75	3.25	4.75
Private Consumption (% y/y)	0.0	3.7	4.1
Government Consumption (% y/y)	2.7	1.7	1.1
Investment (% y/y)	-5.0	6.7	8.1
Fiscal Balance (% GDP)	-4.2	-4.3	-3.6
Current Account (% GDP)	-2.3	-2.5	-2.3

Source: BBVA Research

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